

THE INSTALLMENT SALE-REACQUISITION APPROACH TO REAL ESTATE DEVELOPMENT PROJECTS

ABA Section of Taxation
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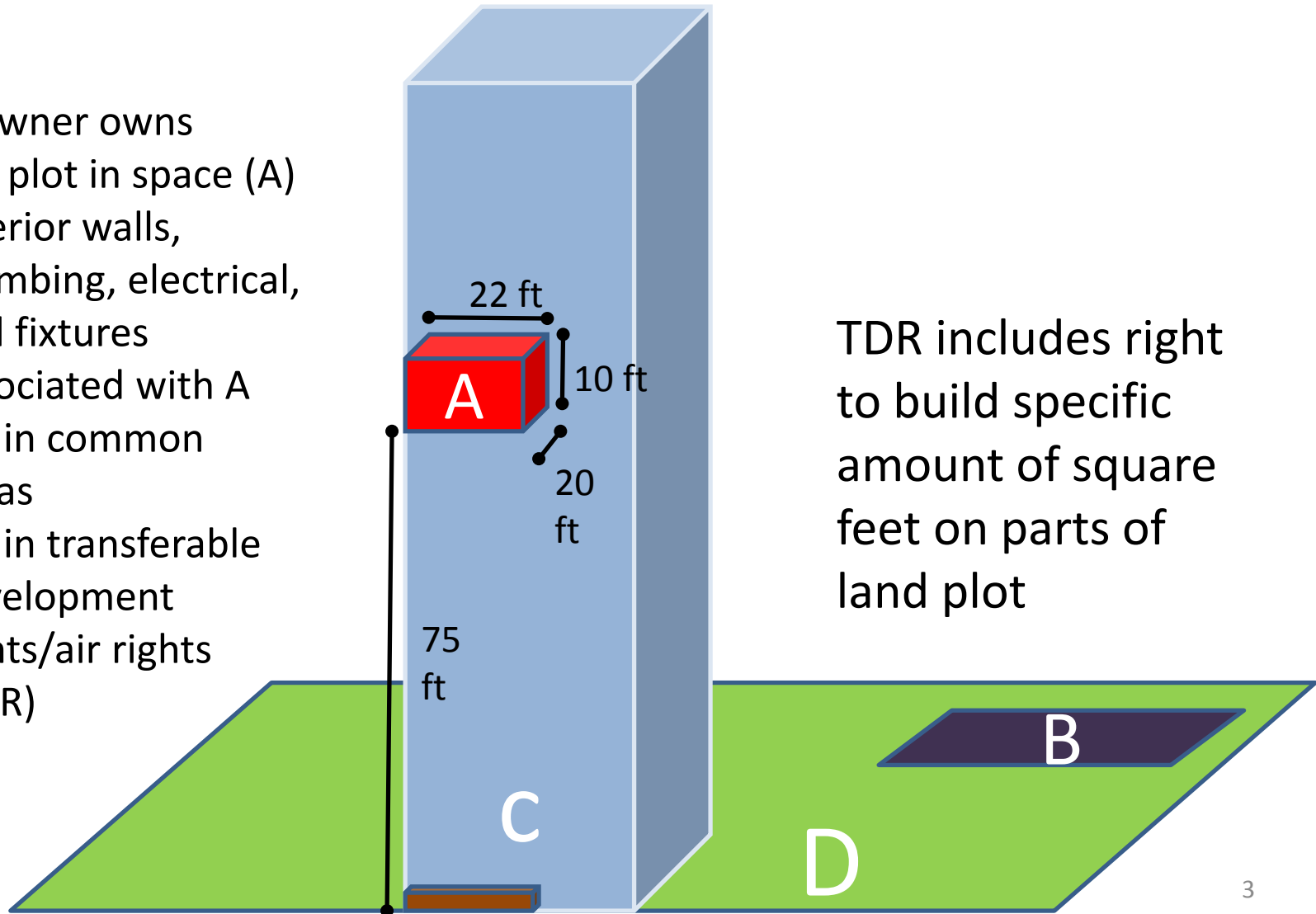
Exchange of Fee Ownership in Land for Condo Units

- Fact Pattern:
 - Taxpayer owns fee ownership in undeveloped land or excess air rights above a building.
 - Developer approaches taxpayer, proposes to build several townhouses on the land, or apartment condominiums in the unused air right space, and deliver one or more of the completed townhouses or condominium apartments to the taxpayer. Developer will keep the remaining portion of the land or air space.
 - Assume: Property to be constructed by Developer will not be completed within 180 days
 - Question: Can Taxpayer avoid gain on these transactions?

Air Right vs. Plot in Space

Condo owner owns

1. the plot in space (A)
2. Interior walls, plumbing, electrical, and fixtures associated with A
3. TIC in common areas
4. TIC in transferable development rights/air rights (TDR)



TDR includes right to build specific amount of square feet on parts of land plot

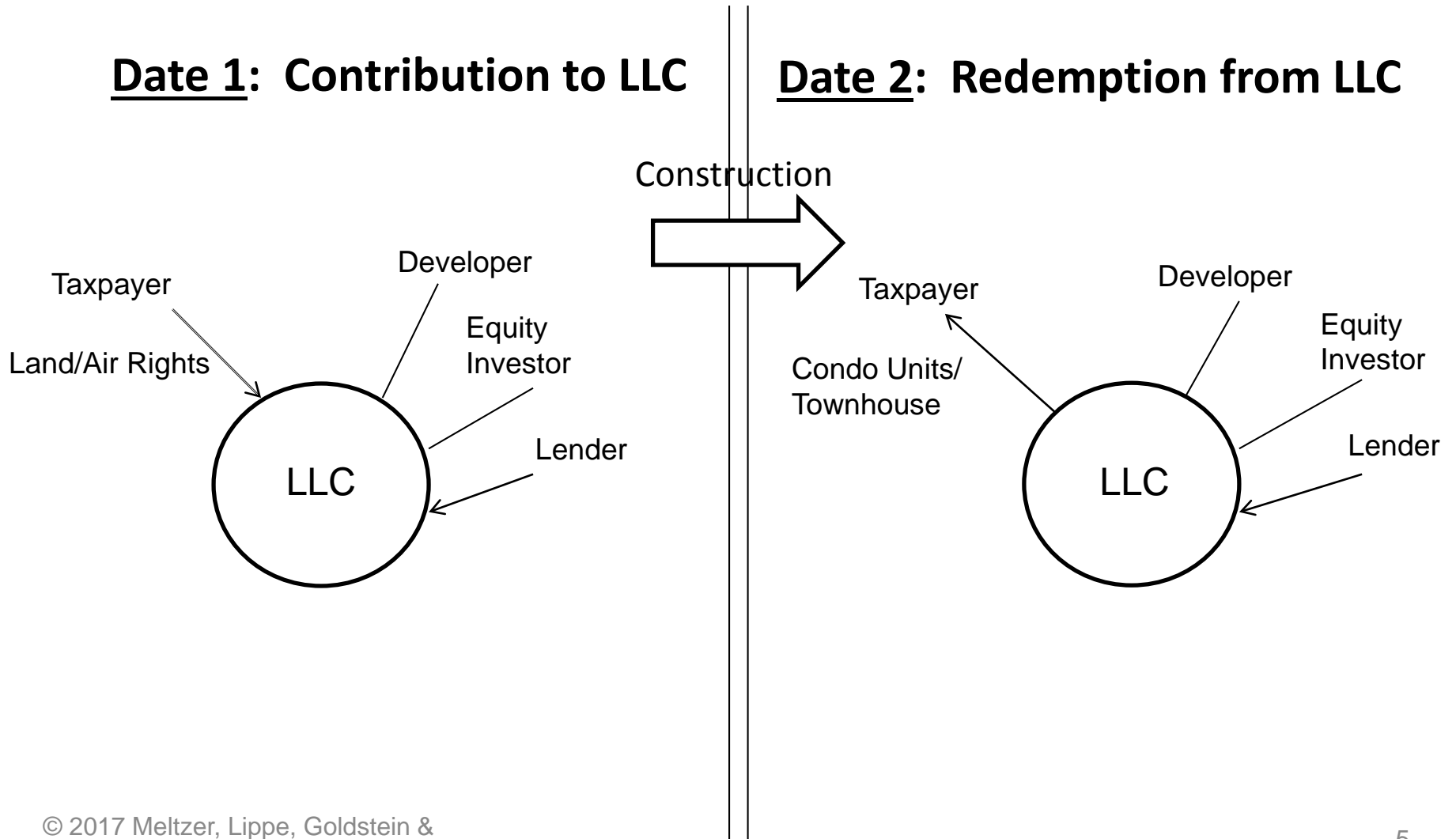
Mixing Bowl: General Strategy

- Taxpayer contributes land or air rights to LLC treated as partnership for tax purposes
 - Developer constructs improvements on the property in the LLC
- LLC agreement provides for liquidating distribution in kind to Taxpayer
 - Practice tip: Taxpayer will want to exit from LLC before LLC has income from sales

Mixing Bowl

Date 1: Contribution to LLC

Date 2: Redemption from LLC



Mixing Bowl: If All Goes Well

- No gain or loss on distribution of property in liquidation of taxpayer's interest in the LLC. IRC 731(a).
- Taxpayer's holding period in distributed property looks to LLC's holding period. IRC 735(b); IRC 1223(1).
- Taxpayer's basis in LLC serves as basis in distributed property. IRC 732(b)-(c).
- If distributed property is “inventory” (as defined in IRC 751(d)), gain or loss on sale or exchange within 5 years of date of distribution treated as ordinary income or ordinary loss.
 - For purposes of IRC 751(d), “inventory” includes property other than a capital asset or property described in section 1231.

Mixing Bowl: Tax Hurdles

1. Disguised Sale of property to partnership or sale of partnership interests. IRC 707(a)(2)(B).
 - But not a disguised sale if LLC's transfer of property to taxpayer is "dependent on the entrepreneurial risks of partnership operations." Reg. sec. 1.707-3(b)(1).
2. Partnership anti-mixing bowl rules. IRC 704(c)(1)(B) and 737.
 - But see: Exception in IRC 704(c)(2) for distribution of "like kind" property to Taxpayer.
 - But see: Regulations under section 737 require actual distribution of taxpayer's contributed property as part of the same distribution. Reg. sec. 1.737-1(c)(2)(iv)-(v).
3. Hot assets. IRC 751(b).
 - Distribution may be treated as sale or exchange if LLC has "hot assets" (substantially appreciated inventory or unrealized receivables) and property distributed to Taxpayer is a capital asset or 1231 property. IRC 751(b).

Section 1031: General Strategy

- Taxpayer separates land into separate lots, owned in part by Taxpayer and in part (for at least 6 months) by an Affiliate of the Taxpayer
- Taxpayer and Affiliate enter into long-term leases (say, 99-year) with Developer requiring market rent
 - Developer constructs improvements on the leaseholds
- Taxpayer acquires put option to sell its fee interest to Developer
- Put option allows for Developer to make payment in kind with leasehold interest, as improved, in lots leased from Affiliate

1031 Strategy: If All Goes Well

- Exchange qualifies for Section 1031 as exchange of fee interest for long-term leasehold
 - See Revenue Ruling 68-394
- Taxpayer's holding period for leasehold replacement property includes holding period for relinquished fee interest. IRC 1223(1).
- Taxpayer's basis in fee interest serves as basis in leasehold replacement property. IRC 1031(d).

1031 Strategy: Tax Hurdles

- Whether taxpayer is treated as selling its fee interest at the time it enters into Lease while holds put option?
- Issue: What is relevant test for determining whether put option will be deemed exercised?
 - Economic compulsion?
 - Reasonably likely?
- Practice tip: Whether to require Taxpayer to take economic haircut if Developer chooses to pay in kind?
- Practice Tip: Leases should have market rent

Installment Sale and Subsequent Reacquisition

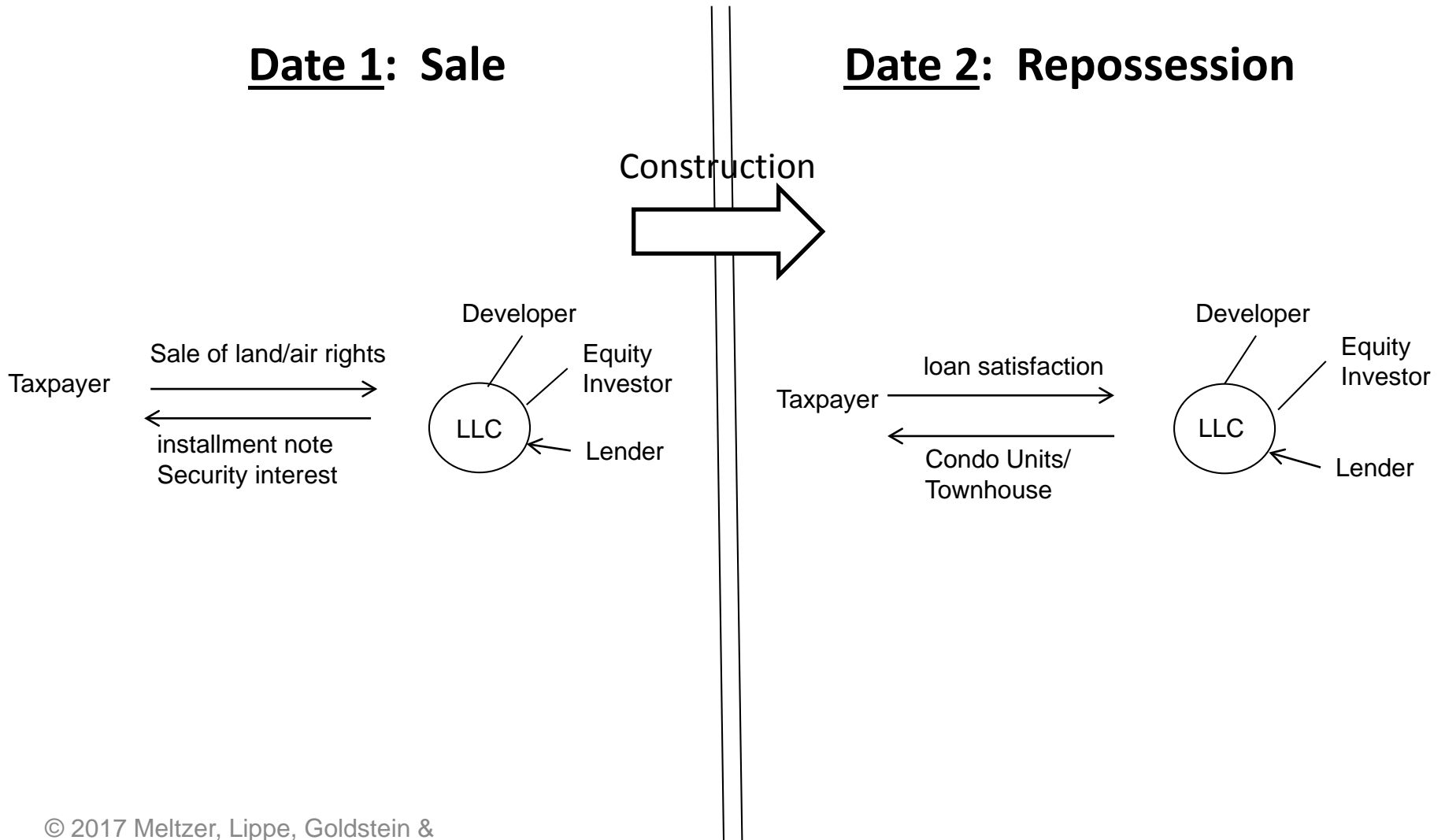
- Taxpayer sells land or air rights to Developer for relatively long-term installment note secured by the property.
 - Developer constructs improvements
- At end of construction, taxpayer receives either townhouse or 1 or more condominium units, as applicable, in repayment of installment note.
- Practice tip: Whether to require Taxpayer to take economic haircut if Developer pays in kind?
- Practice tip: Installment note should provide market rate of interest.

Installment Sale/Reacquisition: Section 1038

- IRC 1038(a) provides:
- General Rule.—If—
 - (1) a sale of real property gives rise to indebtedness to the seller which is secured by the real property sold, and
 - (2) the seller of such property reacquires such property in partial or full satisfaction of such indebtedness,

then, except as provided in subsections (b) and (d), no gain or loss shall result to the seller from such reacquisition, and no debt shall become worthless or partially worthless as a result of such reacquisition.

Sale-Reacquisition Approach



Installment Sale/Reacquisition: Section 1038

- Arguments in Favor of Structuring into Section 1038:
 1. Regulations contemplate taxpayer's reacquiring the property after improvements are added by purchaser.
 2. Section 1038 was enacted to override prior rules under section 453 which treated improvements added by purchaser as taxable boot on reacquisition.
 3. Tax Court has opined that Section 1038 applies where taxpayer sold vacant land to developer and eventually reacquired developed units as payment on the note.

Installment Sale/Reacquisition: Section 1038

- Regulations under section 1038:
 - If Section 1038 applies, tax treatment is mandatory, not elective.
 - Debt is “secured” by real property if Seller has right to take title or possession, or both, if Purchaser defaults. Reg. sec. 1.1038-1(a)(2)(ii).
 - If Seller is not paying additional consideration, Section 1038 generally applies to a reacquisition even if purchaser has not defaulted or default is not imminent.
 - If Seller is paying additional consideration at time of reacquisition, Section 1038 shall apply only if the original sale contract provides for the reacquisition of the property and for payment of additional consideration. Reg. sec. 1.1038-1(a)(3)(i).

Installment Sale/Reacquisition: Section 1038

- In general, gain shall be recognized on reacquisition to the extent that prior payments received by the taxpayer exceed gain recognized in prior periods under the installment method. IRC 1038(b)(1).
 - Overall limitation on gain based on gain realized on original sale minus (i) income previously reported minus (ii) amounts paid by Taxpayer in connection with the reacquisition. IRC 1038(b)(2).

Installment Sale/Reacquisition: Section 1038

- Taxpayer's basis in reacquired property is equal to the sum of (i) its basis in the installment note plus (ii) the amount of gain resulting from reacquisition plus (iii) the amount of money or value of property paid by the Taxpayer in the course of reacquiring the property. IRC 1038(c).
 - Taxpayer's basis on reacquisition will be equal to (i) its basis at the time of original sale plus (ii) amounts paid on reacquisition of the property unless gain resulting from reacquisition is limited under IRC 1038(b)(2).

Installment Sale/Reacquisition: Section 1038

- Taxpayer’s holding period in reacquired property includes its holding period prior to installment sale.
 - Reg. Sec. 1.1038-1(g)(3): “Since the reacquisition described in subparagraph (1) of this paragraph is in a sense considered a nullification of the original sale of the real property, for purposes of determining gain or loss on a disposition of such property after its reacquisition the period for which the seller has held the real property at the time of such disposition shall include the period for which such property is held by him prior to the original sale. However, the holding period shall not include the period of time commencing with the date following the date on which the property is originally sold to the purchaser and ending with the date on which the property is reacquired by the seller.”

Installment Sale/Reacquisition: Example

- Example (1) from Regulations:
- S purchases real property for \$20 and sells it to P for \$100, the property not being mortgaged at the time of sale. Under the contract P pays \$10 down and executes a note for \$90, with stated interest at 6 percent, to be paid in nine annual installments. S properly elects to report the gain on the installment method. After the second \$10 annual payment P defaults and S accepts a voluntary reconveyance of the property in complete satisfaction of the indebtedness. S pays \$5 in connection with the reacquisition of the property. The fair market value of the property at the time of the reacquisition is \$110.

Installment Sale/Reacquisition: Example

Example (1) from Regulations (con't):

- (1) Gain on reacquisition equal to \$6 (equal to excess of prior cash payments of \$30 over \$24 income previously reported on the installment method).
- (2) Basis of reacquired property on date of reacquisition equal to \$25 (equal to sum of (i) \$14 remaining basis in the installment note plus (ii) \$6 gain on reacquisition plus (iii) \$5 paid at time of reacquisition).
 - Big picture: Basis equal to Taxpayer's basis at time of installment sale (\$20) plus \$5 paid at time of reacquisition of the property.

Installment Sale/Reacquisition

- Legislative history: Section 1038 intended to override prior regulations under IRC section 453

Prior Regulations:

- Reacquisition is treated as taxable exchange of promissory note for reacquired property
- See Treas. Reg. 1.453-5(b)(2) and Treas. Reg. 1.453-6(b)(1):
 - In measuring taxpayer's gain on reacquisition of property, fair market value of the property on date of reacquisition includes value on date of reacquisition of fixed improvements placed on the property by the purchaser
- See also Treas. Reg. 1.453-6(b)(2)

Conners v. Commissioner, 88 T.C. 541 (1987)

- Tax Court held that Section 1038 applies both to the reacquisition of land sold to purchaser and improvements constructed on the land by purchaser after the installment sale.

Conners v. Commissioner, 88 T.C. 541 (1987)

- Taxpayer sold land to developer, took back installment note and purchase money deed of trust.
- Purchaser develops condominium units on land.
- After Purchaser defaults, taxpayer agrees to accept 6 condominium units (out of 48-unit project) in lieu of exercising its right to foreclose on the property.
- Issue was whether improvements qualify for 1038 nonrecognition?
 - Parties agreed that section 1038 applied to reacquisition of the land.

Conners v. Commissioner, 88 T.C. 541 (1987)

Tax Court cited legislative history:

- “Congress felt it was inappropriate to measure gain upon repossession of the property by reference to the fair market value at the time of the repossession because (1) the taxpayer was actually in no better position than he was before he made the sale; (2) valuation at the time of the repossession was difficult; (3) to tax the initial seller on gain at the time of repossession was to tax him on gain not yet realized; and (4) because the taxpayer had not received a monetary return with respect to the property, funds to pay the taxes may be unavailable.” 1964-2 C.B. 828, 831.

Conners v. Commissioner, 88 T.C. 541 (1987)

- Tax Court follows Smith v. Commissioner, 58 T.C. 874 (1972) regarding holding period and basis where section 1038 applies:
 - Tack holding period only onto land
 - New holding period in improvements
 - Basis in note becomes basis in land
 - Zero basis in improvements

Cost of Section 1038

- Taxpayer has annual interest income on installment note
- Section 453A interest charge on deferred tax liability while loan is outstanding
 - Unlikely to be a deal breaker in low-interest environment
 - 453A may not be applicable if installment note less than \$5 million